No. 85-855

Supreme Court, U.S.
FILED
FEB 18 1986
JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1985

ARKLA, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

JONATHAN S. COHEN
BRUCE R. ELLISEN
Attorneys

Department of Justice
Washington, D. C. 20530
(202) 633-2217

20pp

QUESTION PRESENTED

Whether the court of appeals correctly held that economically recoverable natural gas used as "cushion gas" to maintain pressure in an underground gas storage facility is not "property with respect to which depreciation * * * is allowable," so that it is not eligible for the investment tax credit.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	1
Argument	5
Conclusion	13

TABLE OF AUTHORITIES

Cases:

A. Duda & Sons, Inc. v. *United States*, 560 F.2d 669 7

Bender v. *United States*, 383 F.2d 656 7

Burnet v. *Niagara Falls Brewing Co.*, 282 U.S. 648 5

Hawaiian Independent Refinery, Inc. v. *United States*, 697 F.2d 1063, cert. denied, 464 U.S. 816 ..... 10, 11, 12

Hawkins v. *Commissioner*, 713 F.2d 347 6

Hertz Corp. v. *United States*, 364 U.S. 122 6

Hibernia National Bank v. *United States*, 740 F.2d 382 6

Hoboken Land & Improvement Co. v. *Commissioner*, 138 F.2d 104 7

Kem v. *Commissioner*, 432 F.2d 961 6

Komas Santa Fe, Inc. v. *Commissioner*, 693 F.2d 71, cert. denied, 460 U.S. 1083 7

Page

Cases—Continued:

Massey Motors, Inc. v. *United States*, 364 U.S. 92 6

Oglebay Norton Co. v. *United States*, 610 F.2d 715 ..... 10, 11

Pacific Far East Line, Inc. v. *United States*, 544 F.2d 478 ..... 10, 11

Real Estate Title Co. v. *United States*, 309 U.S. 13 5

Transwestern Pipeline Co. v. *United States*, 639 F.2d 679 ..... 8, 9, 10

Statutes and regulations:

Internal Revenue Code of 1954 (26 U.S.C.):

§ 38 3

§ 46(c)(2) 8

§ 48(a)(1) (Supp. IV 1980) 3, 5, 8, 11, 12

§ 48(a)(1)(B)(i) 3

§ 48(a)(1)(B)(iii) 3

§ 50 (1976 ed.) 11, 12

§ 50(b) (1976 ed.) 11

§ 50(a)(1)(B) (1976 ed.) 11

§ 167 ..... 5, 8

§ 167(a) 3, 4, 5

§ 6532(a)(1) 3

Page

Statutes and regulations—Continued:

Merchant Marine Act, 46 U.S.C. 1177 *et seq.* 10

Treas. Reg. § 1.167(a)-2 6

Miscellaneous:

Rev. Rul. 75-233, 1975-1 C.B.95 10

In the Supreme Court of the United States

OCTOBER TERM, 1985

No. 85-855

ARKLA, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-7a) is reported at 765 F.2d 487. The opinion of the district court (Pet. App. 9a-29a) is reported at 592 F. Supp. 502.

JURISDICTION

The judgment of the court of appeals was entered on July 15, 1985. A timely petition for rehearing (Pet. App. 8a) was denied on August 20, 1985. The petition for a writ of certiorari was filed on November 18, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner supplies natural gas to customers in five southwestern states. To provide for future gas storage needs, petitioner decided to convert an underground natural gas reservoir in eastern Oklahoma, known as the "Chiles Dome," into a gas storage facility. Petitioner acquired from

the surface owners the right to store gas in the formation, as well as surface rights for drilling wells, laying pipe, and constructing gathering and transmission lines (Pet. App. 2a, 11a-14a). Petitioner also acquired, in fee, a 40-acre tract of land to serve as the compressor site (*id.* at 14a).

In order to operate the storage facility at peak efficiency, petitioner determined that it would be necessary to maintain a certain minimum gas pressure at the intake side of the compressors pumping gas out of the facility into the attached delivery lines. To achieve that pressure, petitioner maintains in the facility a volume of natural gas called "cushion gas" (Pet. App. 2a, 24a). "Cushion gas" is physically indistinguishable from natural gas generally; the term simply refers to the *volume* of gas needed to maintain the desired pressure in the storage chamber (*id.* at 2a, 10a). During 1980, the year the Chiles Dome facility was placed in service, petitioner provided the requisite amount of "cushion gas" by purchasing the native gas already present in the reservoir, and then injecting additional gas purchased from other sources (*id.* at 2a, 18a).

Petitioner created two separate accounting categories for its acquired cushion gas. These categories distinguished between "recoverable" cushion gas (gas that will be commercially removable and marketable when the reservoir is no longer used as a storage facility) and "nonrecoverable" cushion gas (gas that will be lost forever in the storage chamber). See Pet. App. 2a-3a. This separate accounting treatment for "recoverable" and "nonrecoverable" cushion gas was consistent with, and was mandated by, the uniform system of accounts prescribed by FERC. See Pet. App. 3a, 19a. The cost of the cushion gas that petitioner deemed "nonrecoverable" was $193,663. The cost of the cushion gas that petitioner deemed "recoverable" was $9,823,881 (*ibid.*).

2. Section 38 of the Internal Revenue Code[1] provides an "investment tax credit." Property qualifying for the credit is called "section 38 property," and "section 38 property" is defined to include tangible property that "constitutes a facility used * * * for the bulk storage" of gas in connection with the furnishing of gas services. See I.R.C. § 48(a)(1)(B)(i) and (iii). "Section 38 property" is further defined to "include[] only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable" (I.R.C. § 48(a)(1) (penultimate sentence)). The allowance for depreciation is governed by Section 167(a) of the Code, which permits as a deduction "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)" of property used in profit-making endeavors.

On its original 1980 federal income tax return, petitioner claimed an investment tax credit for the cost of the nonrecoverable cushion gas in its Chiles Dome facility. The credit so claimed was in the amount of $22,271, and it was allowed by the Commissioner. See Pet. App. 3a, 21a. Petitioner subsequently filed an amended 1980 return claiming an additional investment tax credit for the cost of the recoverable cushion gas in the facility. The additional credit claimed was in the amount of $1,129,746 (*ibid.*).

After six months passed without the Commissioner's acting on that claim (see I.R.C. § 6532(a)(1)), petitioner brought this refund suit in the United States District Court for the Western District of Louisiana. That court ruled for petitioner (Pet. App. 9a-29a). It rejected the Commissioner's argument that recoverable cushion gas, not being subject to "exhaustion, wear and tear [or] obsolescence"

---

[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the period at issue (the Code or I.R.C.).

(I.R.C. § 167(a)), is not "depreciable property" that qualifies for the investment tax credit. Rather, relying on the fact that recoverable and nonrecoverable cushion gas are physically and functionally identical, the court held that no distinction should be made between them in determining whether they constitute depreciable property (Pet. App. 25a-29a). The court noted that the Commissioner treated petitioner's nonrecoverable cushion gas as depreciable property and hence had allowed an investment tax credit as to it (*id.* at 25a). Recoverable cushion gas, the court concluded, should be treated the same way (*id.* at 29a).

The court of appeals unanimously reversed (Pet. App. 1a-7a). The fact that "recoverable and nonrecoverable cushion gas are physically identical," the court held, "does not require them to be treated identically for depreciation purposes" (*id.* at 5a). To the contrary, the court reasoned (*id.* at 5a-6a), the principles that underlie the allowance for depreciation mandate that the two categories of gas be treated differently:

> The IRS allowed the investment tax credit for the nonrecoverable cushion gas Arkla claimed on its original 1980 federal income tax return because this gas will be unavailable for any use after the useful life of the storage facility ends. In essence, the useful life of the nonrecoverable gas is measured by the useful life of the storage facility. By contrast, the recoverable cushion gas will remain physically unchanged in the storage facility for an indefinite period of time. At any time that the storage facility is closed, the recoverable gas, by definition, will be available for sale or other use, with its general utility and value undiminished in any fashion. [The fact that] the nonrecoverable cushion gas will become obsolete along with the storage facility, while the recoverable cushion gas will not, mandates a

different treatment of the two assets for depreciation purposes.

ARGUMENT

The decision below is correct. Contrary to petitioner's assertion, there is no conflict among the circuits on the question presented. There is no basis for further review.

1. The question whether petitioner is entitled to an investment tax credit for the recoverable cushion gas turns on whether that gas is "property with respect to which depreciation * * * is allowable" within the meaning of Section 48(a)(1). To be depreciable, property must be subject to "exhaustion, wear and tear, [or] obsolescence." I.R.C. § 167(a). Recoverable cushion gas is plainly not subject to "wear and tear" or "exhaustion," because, as the court of appeals observed (Pet. App. 5a), it "will remain physically unchanged in the storage facility for an indefinite period of time." And the court was also correct in concluding that recoverable cushion gas is not subject to "obsolescence" —that is, to loss of value or usefulness because of changing circumstances[2] — because, when the storage facility is closed, "the recoverable gas, by definition, will be available for sale or other use, with its general utility and value undiminished in any fashion" (*id.* at 5a-6a). This result is in contrast to that with respect to the nonrecoverable cushion gas, the depreciability of which is unquestioned, since that gas by definition will *not* be available for any use once the facility is abandoned, but will be "lost" in the storage chamber.

The court of appeals observed that this common-sense result "is supported by several other considerations as well" (Pet. App. 6a). The depreciation deduction allowed by Section 167 is "designed to compensate a taxpayer for actual

---

[2]See *Real Estate Title Co.* v. *United States*, 309 U.S. 13, 15-17 (1940); *Burnet* v. *Niagara Falls Brewing Co.*, 282 U.S. 648, 653-654 (1931).

economic loss" (Pet. App. 6a) by permitting him to recover, free from taxation, the capital that he has invested in the asset. *Massey Motors, Inc.* v. *United States*, 364 U.S. 92, 96 (1960). The depreciation deduction represents a return to the taxpayer, over the property's useful life, of his investment in the property, less any "salvage" value that the property will likely have at the end of its useful life. See *id.* at 104-107; *Hertz Corp.* v. *United States*, 364 U.S. 122, 126-129 (1960). Accordingly, where it is clear that the taxpayer will suffer no economic loss (*e.g.*, where residual or salvage value equals or exceeds original cost), depreciation is not allowable. *E.g., Hibernia National Bank* v. *United States*, 740 F.2d 382, 386-387 (5th Cir. 1984); *Hawkins* v. *Commissioner*, 713 F.2d 347, 353-354 (8th Cir. 1983); *Kem* v. *Commissioner*, 432 F.2d 961, 963 (9th Cir. 1970). Here, because the recoverable cushion gas can be economically removed from the storage facility in the same condition that it was in at the time of its purchase, that gas "does not represent a potential economic loss" to petitioner (Pet. App. 6a). Depreciation for that reason is not allowable.[3]

The court of appeals' conclusion that the economic difference between recoverable and nonrecoverable cushion gas "mandates a different treatment of the two assets for depreciation purposes" (Pet. App. 6a) is likewise supported by the Treasury Regulations. They provide that "[t]he depreciation allowance in the case of tangible property applies *only to that part of the property* which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence." Treas. Reg. § 1.167(a)-2

---

[3]Petitioner's somewhat confusing assertion (Pet. 4, 8, 19-20, 22) that the decision below conflicts with this Court's decisions regarding salvage value seems to be based on the argument that the gas storage facility must be treated as a single unit, rather than as an assemblage of components, for depreciation purposes. As we demonstrate below (pages 7-8, *infra*), that argument is incorrect.

(emphasis added). In specifying that depreciation is allowable only for "that part" of the property that is subject to exhaustion or decay, the Regulation makes it clear that the determination of depreciability must generally be made with respect to the property's separate components. The various components of petitioner's gas storage facility — *e.g.*, the cushion gas, as distinguished from the rest of the facility, and the recoverable cushion gas, as distinguished from the nonrecoverable portion — must thus be treated separately here.

Without specifically challenging the validity of this Regulation (see Pet. 11), petitioner argues that the recoverable cushion gas should not be analyzed separately, but rather that the entire gas storage facility should be deemed "the property" for depreciation purposes, with a single depreciation allowance being computed, claimed, and allowed on the facility as a whole. See Pet. 9, 14, 22, 25-27. This argument is plainly wrong. Petitioner's storage facility is divided into many parts, and the total cost of putting it into service included the cost of many items — land acquisition, acquisition of underground storage rights, construction of wells, purchase and installation of compressors and compressor stations, purchase and installation of various pipelines — besides the cost of the cushion gas (Pet. App. 13a-15a). Not all of these components qualify for depreciation — land obviously does not[4] — and the various components may have different useful lives. Thus, both the eligibility for depreciation and the actual depreciation allowances must *necessarily* be determined on a component-by-component basis. Since eligibility for the investment tax

---

[4]See, *e.g.*, *Lomas Santa Fe, Inc.* v. *Commissioner*, 693 F.2d 71, 72 (9th Cir. 1982), cert. denied, 460 U.S. 1083 (1983); *A. Duda & Sons, Inc.* v. *United States*, 560 F.2d 669, 678 (5th Cir. 1977); *Bender* v. *United States*, 383 F.2d 656, 659 (6th Cir. 1967); *Hoboken Land & Improvement Co.* v. *Commissioner*, 138 F.2d 104, 106 (3d Cir. 1943).

credit depends on depreciability (I.R.C. § 48(a)(1)), and since the amount of the credit depends on the property's useful life (I.R.C. § 46(c)(2)), the investment-credit inquiry must necessarily be conducted on a component-by-component basis as well.

At bottom, petitioner seems to recognize that its position is untenable under traditional depreciation principles, and it accordingly argues that those principles should not apply in determining entitlement to the investment tax credit. "[T]he Fifth Circuit's utilization of the Code § 167 concepts and regulations," petitioner asserts, "is entirely misplaced for Section 38 purposes," on the theory that the two Sections, while having "the common thread and Congressional purpose to stimulate investment in productive resources," supposedly manifest a different "approach" (Pet. 12, 13). This argument is wholly insubstantial. Congress has clearly specified that the investment tax credit is available "only [as to] property with respect to which depreciation (or amortization in lieu of depreciation) is allowable" (I.R.C. § 48(a)(1) (penultimate sentence)). Since the allowance for depreciation is governed by Section 167 — a Section that is entitled "Depreciation" — the words that Congress has placed in Section 48(a)(1) necessarily require "utilization of the Code § 167 concepts and regulations" (Pet. 13) in answering the question presented here.

2. There is no merit to petitioner's contention (Pet. 21-22) that the decision below conflicts with *Transwestern Pipeline Co.* v. *United States*, 639 F.2d 679 (Ct. Cl. 1980). That case involved a depreciation deduction for "line pack" gas — natural gas that must initially be injected to fill gas pipelines and must remain in those pipelines to maintain customer service. The Court of Claims considered the "line pack" gas as a unit and held that it was a capital asset depreciable over the useful life of the pipeline system (*id.* at 680-681). The court found that, at the end of the pipeline's

useful life, 88% of the gas would be nonrecoverable and 12% would be recoverable. The court accordingly concluded that the "line pack" gas had a total salvage value equal to 12% of its original cost, and hence that the total depreciation had to be limited to 88% of the original cost (*id.* at 688). The effect of the Court of Claims' decision was thus to treat the entire line pack as "depreciable property," but to disallow depreciation on the recoverable portion of it.

The court below correctly held (Pet. App. 6a) that *Transwestern* "is distinguishable from the instant case." The government's sole argument in *Transwestern* was that *all* of the line pack gas constituted "inventory" and was thus entirely ineligible for depreciation. Under those circumstances, the analytical difference between the recoverable and the nonrecoverable gas was not important. It was immaterial whether the *Transwestern* court, in rejecting the "inventory" argument, held that the entire line pack was depreciable property, subject to a limitation on depreciation arising from the 12% salvage value, or whether it held that only the 88% nonrecoverable portion of the line pack was depreciable property, having no salvage value. In either event, the amount of the depreciation allowance would be exactly the same. Here, on the other hand, the investment credit outcome depends entirely on the characterization of the recoverable cushion gas as depreciable or nondepreciable property, and the instant case thus presents an issue that there was no need to decide in *Transwestern*.

Indeed, to the extent that any inference may be drawn from *Transwestern* about how the Court of Claims' successor would decide the question presented here, that opinion suggests that the Federal Circuit would reach the same result that the Fifth Circuit reached below. The *Transwestern* court, in holding the taxpayer entitled to depreciation to the extent the line pack gas was nonrecoverable, relied in part on a revenue ruling in which the Commissioner ruled

that nonrecoverable cushion gas in an underground gas storage facility is depreciable property whereas recoverable cushion gas is not. See 639 F.2d at 681 (citing Rev. Rul. 75-233, 1975-1 C.B. 95). The position that the Commissioner took in that ruling, of course, is identical to his position here. There is thus no reason to believe that the Federal Circuit would decide this case differently than the Fifth Circuit did.

3. Petitioner likewise errs in contending (Pet. 7-19) that the decision below conflicts with *Hawaiian Independent Refinery, Inc.* v. *United States*, 697 F.2d 1063 (Fed. Cir.), cert. denied, 464 U.S. 816 (1983), *Oglebay Norton Co.* v. *United States*, 610 F.2d 715 (Ct. Cl. 1979), and *Pacific Far East Line, Inc.* v. *United States*, 544 F.2d 478 (Ct. Cl. 1976), decisions that petitioner did not cite in either court below. *Pacific Far East Line* and *Oglebay Norton* involved the question of eligibility for the investment tax credit of ships paid for with funds from certain tax-deferred reserves established under the Merchant Marine Act, 46 U.S.C. 1177 *et seq.* In *Pacific Far East Line*, the taxpayer had paid for part of the cost of two ships with such tax-deferred funds. By statute, the taxpayer was not permitted to include that part of its purchase price in its "basis" for purposes of depreciating the ships. The Court of Claims rejected the government's argument that only that portion of the ships' cost that was depreciable was eligible for the investment tax credit, concluding that the entire cost of the ships qualified for the credit "irrespective of the source of the funds invested" (544 F.2d at 484). In *Oglebay Norton*, the taxpayer had paid for the entire cost of refurbishing three ships with tax-deferred funds. Relying on *Pacific Far East Line*, the Court of Claims held that the entire cost was eligible for the investment tax credit, even though no depreciation was actually allowable (610 F.2d at 724-727).

There is no conflict between those two decisions and this one. In both of th se cases it was clear that the property involved was, *by its nature*, "property with respect to which depreciation * * * is allowable" within the meaning of Section 48(a)(1). It was only the source of funds used to pay for the property that, in the government's view, rendered it partially or wholly ineligible for depreciation. Here, by contrast, there is no doubt that the recoverable cushion gas, by its nature, is not depreciable property, since it is not subject to exhaustion, wear and tear, or obsolescence. *Pacific Far East Line* and *Oglebay Norton* are thus irrelevant here, and the decision below is not in conflict with them.

There is likewise no merit to petitioner's assertion (Pet. 16-19) that the decision below conflicts with *Hawaiian Independent Refinery*. The issue there involved interpretation of former Section 50 of the Code, the provision that reinstated the investment tax credit in 1971 after it had been terminated in 1969. See 26 U.S.C. (1976 ed.) 50. Under that provision, in the case of property whose construction began before April 1, 1971, only that portion of the basis attributable to construction after August 15, 1971, was eligible for the investment tax credit (26 U.S.C. (1976 ed.) 50(b)). On the other hand, if the taxpayer began construction on or after April 1, 1971, the full cost of the property qualified for the credit (26 U.S.C. (1976 ed.) 50(a)(1)(B)).

The taxpayer in *Hawaiian Independent Refinery* began construction of an oil refinery complex, consisting of a refinery and two offsite components (a tanker-mooring facility and refined products pipelines) in January 1971. The taxpayer argued that the two offsite components should be considered separately from the refinery, and that they were therefore fully eligible for the credit, because construction on them did not begin until after April 1, 1971. The court rejected this argument, concluding that the two

offsite components, in conjunction with the refinery, functionally formed a single property for purposes of Section 50, since the refinery complex was conceived, designed, and constructed as a unit (697 F.2d at 1069). Accordingly, the court concluded that, for purposes of Section 50(b), the refinery complex constituted a single property, the construction of which began in January 1971.

Petitioner's assertion that the court in *Hawaiian Independent Refinery* "held that the 'Section 38 property' is the entirety of a functionally coherent facility, not its individual component parts" (Pet. 19) is plainly wrong. The issue there concerned the determination of what constituted "a single property for purposes of section 50" (697 F.2d at 1069). Resolution of that issue depended, in part, on the congressional intent behind the peculiar transitional rules of Section 50 for property constructed by the taxpayer (*id.* at 1069 n.13). The *Hawaiian Independent Refinery* decision thus has no bearing on the question whether recoverable cushion gas should be considered separately from nonrecoverable cushion gas (and from the entire storage facility) for purposes of determining whether it is "property with respect to which depreciation * * * is allowable" within the meaning of Section 48(a)(1).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

JONATHAN S. COHEN
BRUCE R. ELLISEN
Attorneys

FEBRUARY 1986

DOJ-1986-02